No. 15270

In the United States Court of Appeals for the Ninth Circuit

ROBERT AZEVEDO, IRENE KERSHAW AND PAUL KERSHAW, JR., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases:

Cases—Continued

Statutes:

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 45-77) are not officially reported.

JURISDICTION

This review involves federal income taxes for the tax year 1946. (R. 3, 26.) On May 13, 1953, the Commissioner of Internal Revenue mailed the taxpayers notices of deficiencies in the total amount of $118,071.22, attributable to Robert Azevedo for $65,020.05, Paul Kershaw, Jr., for $25,943.07, and Irene Kershaw for $27,108.10. (R. 13, 45, 62.) Within ninety days thereafter and on August 3, 1953, the taxpayers filed peti-

tions with the Tax Court for redetermination of the deficiencies under the provisions of Section 272(a) of the Internal Revenue Code of 1939. (R. 3, 22.) The decisions of the Tax Court were entered May 7, 1956. (R. 77-79.) Petitions for review by this Court were filed June 25, 1956. (R. 80-85.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the income from sales of wine during the months from March through June, 1946, is taxable to Robert Azevedo and Paul Kershaw, Jr., as the Tax Court held, or whether the income is taxable to the corporation, Mills Winery, Inc.

STATUTES INVOLVED

The pertinent provision of the statutes involved are set forth in the Appendix, *infra*.

STATEMENT

This appeal involves Robert Azevedo and Paul Kershaw, Jr. Irene Kershaw, Paul Kershaw's wife, is a party only because of the tax effect of California's community property law. (R. 46.)

Robert's father, John Azevedo, was engaged in the construction contracting business in 1945, and also owned a winery near Sacramento, consisting of realty and five buildings, known as Mills Winery. The adjusted basis of the winery property to John Azevedo was $100,000 in 1945. Before July, 1945, John Azevedo did not have the permits required to make and sell wine, and therefore leased the winery to Christian Brothers Winery. At about the end of June, 1945, the lease of

the winery terminated and in July, 1945, the necessary basic permits to make and sell wine and distilled spirits were issued John Azevedo by the Federal Alcohol Tax Unit of the Bureau of Internal Revenue and the California State Board of Equalization. John then commenced operations as a sole proprietor doing business under the name of Mills Winery. (R. 46-47.) In July, 1945, he employed Paul Kershaw, a salesman, to take care of sales, and employed Robert as the wine maker. (R. 33-34.)

In the fall of 1945, John borrowed $440,000 from the Capital National Bank of Sacramento for the purpose of buying grapes for the making of wine and he gave his note to the bank for the loan. Also, a checking account was established in Capital National Bank for the operation of Mills Winery. John Azevedo was the only person authorized to sign checks on and withdraw funds from this account during 1945 and until about August 1, 1946. (R. 47.)

In about August, 1945, John made an oral agreement with Robert and Kershaw to sell them the winery at "adjusted cost." (R. 34.) On or about December 1, 1945, after the fall crush but before the sale of any of the wine, the oral agreement was reduced to writing. (R. 34, 48.) The written contract reads in material part as follows (R. 20-21):

> 1. It is mutually understood and agreed by and between the parties that seller will sell to purchasers that certain winery known as Mills Winery, located at Mills Junction, California, together with all the assets pertaining thereto for the adjusted cost of said winery, plus all other of said winery, including inventory at cost price.

2. Purchasers agree to purchase said winery hereinbefore mentioned under the terms and conditions stated in paragraph 1, above.

3. It is mutually understood and agreed that seller shall remain the owner of said property until such time as the purchasers shall be permitted to receive in their name certain basic permits which will enable them to purchase and own said winery and operate the same; provided, however, that purchasers shall, on January 1, 1946, operate and manage said winery for seller until said time as purchasers shall be able to make actual purchase of said winery, provided further that the compensation for said management, purchasers shall receive as salary the earnings of said business during said period of management.

4. It is further mutually agreed and understood by the parties hereto that unless the above mentioned permits are issued in the names of purchasers on or before January 1, 1947, this agreement shall at the option of seller be declared null and void.

5. It is hereby understood and agreed by the parties hereto that this agreement shall apply not only to the parties hereto but to their assigns.

In Witness Whereof, the parties hereto have hereunto set their hands the day and year first above written.

Signed—John Azevedo
Robert Azevedo
Paul Kershaw, Jr.

Commencing in August, 1945, Kershaw bought grapes for the fall 1945 crush. Robert performed the services of winemaker. John, although engaged in the contracting business, was present at the winery to supervise some construction work, and he also attended to financial transactions with Capital National Bank. The cost of the construction work was $10,000. By December 1, 1945, the fall crush was completed and an inventory of wine was in process of manufacture. No wine was sold during 1945. All of the wine produced from the 1945 crush was sold during four months in 1946, namely, March, April, May, and June. (R. 47-48.) The sales were bulk sales in large quantities to Italian Swiss Colony Wine Company, Petri Wine Company, and Christian Brothers Wine Company. The invoices for the sales bore the name, "Mills Winery." (R. 42, 52.)

The Commissioner determined, and the taxpayers concede, that the net profit derived from the sale was $202,113.82. The Capital National Bank was repaid the loan made to John, $440,000, out of the proceeds from the sales. (R. 51, 52.)

Robert and Kershaw paid John $110,000 in installments during March, April, June, and July. The payments were made out of the proceeds of the sales of wine. The sum of $110,000 represented John's adjusted basis of the Mills Winery property plus $10,000 for improvements, which was the consideration stated in the purchase and sale agreement dated December 1, 1945. On July 4, 1946, when the last installment was paid John, he was still on the premises of Mills Winery. (R. 51-52.)

On March 4, 1946, Robert and Kershaw filed with the Secretary of State of California articles of incorpora-

tion of a corporation named "Mills Winery, Inc," to be engaged in producing and selling wine and distilled spirits. (R. 33, 52, 132.) The directors held their first meeting on March 20, 1946. At this meeting by-laws were adopted, Robert was elected president of the corporation, and Kershaw was elected vice-president, secretary, and treasurer. (R. 52.)

At a meeting of the directors on August 12, 1946, a resolution was adopted authorizing the issuance of 20,000 shares of capital stock of the par value of $100 per share, 10,000 shares each to be issued Robert and Kershaw. (R. 52-53.) Application for such stock issue was filed with the California Corporation Commissioner on September 18, 1946. (R. 54.) The application was granted on October 2, 1946, subject to the restriction that the stock be placed in escrow. Thereafter the corporation issued 10,000 shares each in the names of Robert and Kershaw but the stock was immediately placed in escrow with their attorney of record in this case, Robert C. Burnstein. At the time of the trial of these cases, all of the stock was still held by Burnstein in escrow. The escrow requirement was in accordance with the laws of California. (R. 56-57.)

On May 1, 1946, Treasury Form 698 had been executed on behalf of John Azevedo, doing business as "Mills Winery," and filed with the Federal Alcohol Tax Unit. In the Form 698 John Azevedo advised the Alcohol Tax Unit that he intended his basic permits to conduct a winery for the manufacture of wine and the distilling of spirits to be discontinued as of the date similar basic permits and licenses were issued to "Mills Winery Inc." (R. 37, 55.)

On May 3, 1946, the corporation Mills Winery, Inc.,

made application to the federal authorities for basic permits to produce, blend, distill, and sell wine and spirits. Attached to the application was the following sworn statement (R. 37, 55):

> Applicant's place of business will be purchased from John Azevedo, an individual and the present owner, when proper permits are received by applicant to engage in the operations of a Fruit Distillery.

A wine producer's and blender's basic permit and a distiller's basic permit were issued by the Alcohol Tax Unit of the Bureau of Internal Revenue under date of August 13, 1946, effective August 7, 1946. On about August 12, 1946, but before that date, the California State Board of Equalization issued to Mills Winery, Inc., a wine manufacturers' license and a distilled spirits manufacturers' license. (R. 55-56.)

By a grant deed dated June 21, 1946, John Azevedo and Frances Azevedo, as grantors, granted to Mills Winery, Inc., all the real property upon which the Mills Winery premises and equipment were located. The deed was held in escrow. The escrow instructions do not contain information regarding the delivery of the deed nor the length of time it was to be held in escrow, nor does the record establish when it was delivered to Mills Winery, Inc. The deed was recorded with the Recorder of Sacramento County on November 23, 1946. (R. 56.)

After the organization of Mills Winery, Inc., on March 4, 1946, various activities were carried on by Robert and Kershaw as officers and directors. All of these activities, such as contracting with certain individuals concerning the distilling of spirits during the

fall, 1946 season, and entering into written contracts with the Southern Pacific Company, were transacted by Robert and Kershaw on behalf of and in their capacity as officers of Mills Winery, Inc. (R. 38-39, 57-58.)

Certain improvements and alterations on the winery premises were made from June through August, 1946, which were paid for by the corporation. (R. 58.)

The corporation did not file application Form SS-4 for an Employer's Identification Number until August 8, 1946, and the notifications of change in ownership of insurance policies and motor vehicles were not made by the corporation until August, 1946, or subsequently. (R. 58.)

At all times material there was a single checking account in the Capital National Bank of Sacramento, California, for the business operations of Mills Winery. During the period of August 1, 1945, to August 1, 1946, John Azevedo had the sole authority to sign checks and withdraw funds from this account. On and after August 1, 1946, Robert and Kershaw were granted permission to withdraw funds from the bank account on behalf of the corporation. (R. 59.)

It was stipulated that Robert and Kershaw had prepared for filing with the Bureau of Internal Revenue a partnership income tax return for the period August 1, 1945, to March 1, 1946, which reflected a closing inventory on the latter date of $445,467.09. (R. 34-35.) However, the records of the Commissioner of Internal Revenue do not show that a partnership return was filed for any period or for the period August 1, 1945, to March 1, 1946 (R. 59), and no proof was offered that such a return was ever filed (see R. 93-95). The

prepared return appears not to have been signed. (Ex. 3-C.)

A financial statement stated that a partnership of Robert and Kershaw had an inventory as of March 3, 1946, of $445,467.09. (R. 35.) This statement was prepared by the accountants "without audit." (R. 36.) Nowhere did the Commissioner concede the truth of the facts set out in the financial statement. The Commissioner merely stipulated that the statement existed. (R. 35.)

A corporation income tax return, and an amended corporation return was filed for Mills Winery, Inc., for the taxable period March 4, 1946, to March 3, 1947, which returns reflect the net income from the sales of wine here in question. These returns state the opening inventory to be $445,467.09. (R. 60-61.)

The Commissioner admits that corporate books were opened for Mills Winery, Inc., as of March 4, 1946, and that all sales of wine made during the period March 4, 1946, to August 6, 1946, were "picked up" as corporate gross profit when the corporate returns were filed. (R. 25, 42-43, 164.) Taxpayer conceded that the expression "picked up" meant merely that the sales were reported on the books and returns as corporate gross income. (R. 164.) Nowhere did the Commissioner concede that the income from the sales was the income of the corporation.

In the minutes of a special meeting of the directors of Mills Winery, Inc., on August 12, 1946, a resolution was adopted which provided that Robert and Kershaw were to pay to the corporation in cash $55,000, each, or $110,000 for the purpose of obtaining the deed from John and Frances Azevedo to the real property where

the Mills Winery is located. The sum of $110,000 was never paid to the corporation by Robert and Kershaw. A liability of $110,000 owed by them was first reflected on the balance sheet of the corporation return filed for the period of March 1, 1951, to February 29, 1952. (R. 61.)

On October 17, 1946, Robert sold all of his stock in Mills Winery, Inc., to Paul Kershaw for $50,000. (R. 62.) The loss on this sale was recognized by the Commissioner for tax purposes. (R. 65.)

The individual returns for 1946 of Robert Azevedo, Paul Kershaw, Jr., and Irene Kershaw were filed on March 7, 1947, March 15, 1947, and March 20, 1947, respectively. (R. 62.) These returns did not reflect any of the $202,113.82 of net profit from the sales of wines from the 1945 crush. (R. 64-65.)

Consents were executed by Robert Azevedo on February 26, 1952, and by Paul Kershaw, Jr., and Irene Kershaw on January 22, 1952, extending to June 30, 1953, the time within which the income tax for the year 1946 might be assessed. (R. 62.) The notices of deficiencies which have given rise to these cases were mailed by the Commissioner on May 13, 1953. (R. 62.)

The Tax Court found that title to the winery did not pass to Mills Winery, Inc., until sometime after August 12, 1946, and that John Azevedo did not sell the wine inventory from the 1945 crush to Robert and Kershaw or to the corporation before the wine was sold. (R. 62.)

The Tax Court held that of the $202,113.82 earned from the sale of the 1945 crush, 50 per cent or $101,056.91 was attributable each to Robert Azevedo and Paul Kershaw as compensation and salary for their services in the operation and management of Mills

Winery, and for their services in making and selling the wine from the 1945 crush during the period January 1, 1946, to August 6, 1946. The Tax Court held that these net earnings were not the earnings of the corporation, Mills Winery, Inc. (R. 63.)

The Tax Court found that since the income in question was taxable to taxpayers, each taxpayer had omitted from his and her gross income an amount properly includable therein which is in excess of 25 per cent of the amount of gross income stated in the individual returns, and therefore held that the notices of deficiencies, having been mailed before the date specified in the consents extending the period of limitations, were timely and the deficiencies were not barred by the statute of limitations. (R. 63-64, 76-77.)

SUMMARY OF ARGUMENT

I

Income earned from the sale of goods or property is taxable to the person who owned the property at the time the income was produced. At the time of the sales of the wine from the 1945 crush, and at all times before, the wine was owned by John Azevedo. At no time was the wine owned by Mills Winery, Inc. Therefore, the income was not attributable or taxable to Mills Winery, Inc.

By the terms of the December 1, 1945, contract the taxpayers were to continue in their capacity as managing employees of the winery, which, along with the inventory of wine, was to remain the property of their employer John Azevedo until basic permits were issued authorizing the taxpayers to engage in the production and sale of wine. For their services they were to re-

ceive "compensation" and "salaries" measured by the net profits from the winery. Their status as employees of John Azevedo did not change until the basic permits were issued, effective as of August 7, 1946. The net earnings of the business to that date were, by the terms of the contract, taxable fifty per cent each to Robert and to Kershaw individually as compensation and salary for their services in managing and operating John Azevedo's winery.

Until new basic permits were issued it would have been illegal for either the taxpayers or their corporation to produce, distill, or sell at wholesale any wine or spirits. It was to avoid any possible infraction of the law that the ownership of the winery and the wine remained in John Azevedo until the proper permits were issued. Thus in applying for its permits, the corporation was careful to point out that it had not yet acquired the winery and would not do so until the permits were issued. Their basic purpose to stay within the law is entirely inconsistent with the contention that the corporation owned and sold the wine.

The Tax Court's holdings that the wine was at all times the property of John Azevedo, and that the income from the sales was taxable to Robert and to Kershaw individually as compensation and salaries, are not at all in conflict with the stipulation of facts. The Tax Court gave careful attention to all the evidence including the stipulation of facts. That the taxpayers' entire case apparently rests on the contention that the Commissioner stipulated himself out of court, demonstrates the weakness of their case.

II

Under Section 275(c) of the Internal Revenue Code of 1939, the period of limitations for an assessment of a deficiency is five years if the taxpayer has omitted from gross income more than twenty-five per cent of the amount stated in the return which is properly includable therein. Taxpayers having failed to report the income in question, the five-year statute of limitations was applicable. Consents extending the time to June 30, 1953, within which the 1946 deficiencies could be assessed, were executed by the taxpayers before the five-year period had expired. Therefore, under Section 276(b) of the Internal Revenue Code of 1939, the deficiency notices, which were mailed on May 13, 1953, were timely.

ARGUMENT

I

The Income From the Sales of Wine During the Months From March Through June, 1946, Is Taxable Individually to Robert Azevedo and Paul Kershaw, Jr., as Compensation and Salary

The issue in this case is whether the net income from the sales of wine from March through June, 1946, is taxable to the taxpayers as the Tax Court held, or was earned by Mills Winery, Inc. It is basic to income tax law that income is taxed to him who earns it. *Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Eubank,* 311 U.S. 122; *Strauss* v. *Commissioner,* 168 F. 2d 441 (C.A. 2d), certiorari denied, 335 U.S. 858. Income earned from property, or produced by the sale of goods or property, is taxable to the person who owned the property at the time the income was produced. *Corliss* v. *Bowers,* 281 U.S. 376; *Blair* v. *Commissioner,* 300 U.S. 5; *Helvering*

v. *Horst,* 311 U.S. 112; *Harrison* v. *Schaffner,* 312 U.S. 579; *Commissioner* v. *Reece,* 233 F. 2d 30 (C.A. 1st). Taxpayers' theory is that the wine was owned by the corporation during the period of the sales, and is thus taxable to it. The Commissioner's position is that the wine was at all times owned by John Azevedo, and that the taxpayers received salaries or compensation taxable to them individually under Section 22(a) of the Internal Revenue Code of 1939. (Appendix, *infra.*)

In July, 1945, John Azevedo *employed* Kershaw to manage sales of wine, and *employed* his son Robert as a wine maker. (R. 33-34.) In August, 1945, John orally agreed to sell Robert and Kershaw the winery. This agreement was reduced to writing on December 1, 1945, before the sale of any wine from the 1945 crush. (R. 34, 48.) By the terms of this written contract John Azevedo was to sell, and Robert and Kershaw to purchase, Mills Winery at John's adjusted cost, plus all other appurtenances "including inventory at cost." (R. 20.) It was expressly specified (R. 20-21) that John Azevedo was to remain the owner—

> until such time as the purchasers shall be permitted to receive in their name certain basic permits * * *

and furthermore (R. 21) that the

> purchasers shall, on January 1, 1946, operate and manage said winery for seller until said time as purchasers shall be able to make actual purchase of said winery, provided further that the *compensation for said management,* purchasers shall receive *as salary* the earnings of said business during said period of management. (Italics supplied)

It is seen that by the terms of the written contract Robert and Kershaw were to continue in their capacity as employees of John Azevedo, and John was to retain title to the winery, which included the inventory, until the purchasers received the basic permits authorizing them to engage in the production and sale of wine and distilled spirits.

The objective of the parties is immediately apparent. The purchasers were legally disabled from engaging in producing, distilling, or purchasing for resale at wholesale, wines and spirits without obtaining the necessary basic permits from the Federal Government and from the State of California. See Section 3 of the Federal Alcohol Administration Act (Appendix, *infra*). Until the basic permits were issued to Mills Winery, Inc., on August 13, 1946, the taxpayers assiduously avoided any action which might be construed as a violation of the law. And John Azevedo carefully preserved his basic permits until the corporation acquired permits of its own. Thus John Azevedo, in advising the Alcohol Tax Unit of his intention to give up his permits, expressly postponed the date of expiration of such permits until similar basic permits were issued to Mills Winery, Inc. (R. 37, 55.) Similarly, in applying for its permits, the corporation was careful to point out that it had not yet acquired the winery and would not do so until the permits were issued authorizing it to engage in operations. (R. 37, 55.)

The parties certainly acted carefully, and properly, in avoiding a violation of the law. But this very fact is entirely inconsistent with the contention of the taxpayers that the corporation owned and sold the wine. It was impossible for the corporation to have legally

owned and sold the wine until issuance of the basic permits. Section 3 of the Federal Alcohol Administration Act (Appendix, *infra*). And the permits were not issued until after the wine had been sold.

Furthermore, the checking account was established for the operation of Mills Winery, the sole proprietorship of John Azevedo. (R. 47.) This was the only account drawn on for the business operations here in question, and John Azevedo had the sole authority to sign checks and withdraw funds from this account. Not until August, 1946, when the basic permits were issued Mills Winery, Inc.,—and after the wine in question had been sold—did either of the taxpayers have permission to withdraw funds from the bank account on behalf of the corporation. (R. 55-56, 59.)

And the loan of $440,000, used to purchase the grapes for the 1945 crush, was taken out by John Azevedo. (R. 47.) Since he alone was liable on the note to the Capital National Bank (R. 47), the repayment of this loan from the proceeds of the sales of the wine also shows that John Azevedo, as the proprietor of Mills Winery, was the owner and vendor of the wine. This is completely consistent with the written contract of December 1, 1945.

There is yet further evidence that the wine was owned and sold by John Azevedo. The wine produced from the 1945 crush was sold wholesale to Italian Swiss Colony Wine Company, Petri Wine Company, and Christion Brothers Wine Company. The invoices for the sales bore the name "Mills Winery", and not "Mills Winery, Inc." (R. 42, 52.) This is especially significant since, as we are willing to concede, after March 4, 1946, the corporation Mills Winery, Inc., transacted several matters in all of which it was specifically de-

scribed as a corporation. Thus the written contract executed by Kershaw on April 9, 1946, with certain other persons in connection with the fruit season of 1946, described the party of the first part as "Mills Winery, a California Corporation." (Ex. 6-F; R. 38.) And the written contracts entered into with the Southern Pacific Company on May 11 and 23, 1946, described the party of the second part as "Mills Winery, Incorporated" and were signed by Robert Azevedo as President of "Mills Winery, Incorporated." (R. 38-39; see Exs. D and E attached to Pets. to the Tax Court.)

It is apparent that in all matters where the taxpayers intended the corporation to be a party, the evidence of the transaction accurately described the participating party as a corporation. It is clearly no mere oversight, therefore, that the invoices for the sales in question state that the sales were made by "Mills Winery", John Azevedo's business, and not by the corporation. This factor is emphasized by the fact that the taxpayers did not offer in evidence the checks from the vendees on the sales of approximately $700,000. (R. 51.) We must assume that the payee was "Mills Winery," and not "Mills Winery, Inc.," particularly since the only bank account in existence was that of the sole proprietorship.

It should be noted that the question is not, as taxpayers conceive it (Br. 21), whether the corporation was a sham. We readily concede that the corporation was *bona fide*. The question is merely whether it owned and sold the wine from the 1945 crush. The answer is that even though it was organized as of March 4, 1946, and even though it transacted certain matters which did not require permits, it was legally unable to engage in the claimed activities, namely, buying and re-

selling the wine. And all of the evidence shows that in arranging the sale, in applying for the basic permits, and in all other matters relating to the production and sale of wine, the taxpayers adhered strictly to the letter of the law, which forbade these sales except by a person possessing the basic permits.[1] It was for that reason that the contract of December 1, 1945, specifically retained title in John Azevedo to the winery and the inventory of wine until the taxpayers or the corporation obtained the basic permits.

As further proof that the corporation did not engage in producing and selling wine until after the permits were issued is the fact that the notifications of change in ownership of the winery insurance policies and motor vehicles were not made until August, 1946, or thereafter. (R. 58.)

At about the time when all of the wine had been sold,

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[1] Section 3(c) of the Federal Alcohol Administration Act (Appendix, *infra*). Taxpayers' statement (Br. 19) that the corporation would not have required a permit for the sales in question is obviously incorrect. To begin with, the wine was not disposed of in one isolated sale so as to warrant a claim that the vendor was not engaged in the business. The wine was disposed of through many sales over a four-month period to three large wine companies, Italian Swiss Colony, Petri, and Christian Brothers. (R. 42.) *Supreme Malt Products Co.* v. *United States*, 153 F. 2d 5 (C.A. 1st), which involved one isolated sale, is, therefore, clearly distinguishable.

In any event the corporation was organized to distill, produce, and sell wine. After issuance of the basic permits in August, 1946, it commenced such operations. If it had bought and sold the wine in question, the sales would have been in such close proximity and so related to the activities conducted after August that it could not reasonably be argued that the disposition of the wine in question constituted an isolated transaction having no connection with the corporation's regular business activities. Therefore, had the corporation in fact bought and sold the wine, it would have been in violation of law, the very thing taxpayers were so alert to avoid.

and on June 21, 1946, John Azevedo and his wife executed a deed to the real property and equipment of the winery to the corporation. But the deed was not immediately delivered, it being held in escrow for a period of time. The record does not show when the deed was delivered, but it is reasonable to assume that the date of delivery may have been around November 23, 1946, when it was recorded. (R. 56.) So far as the record indicates, there was no transfer of ownership until sometime after the basic permits were issued the corporation, and such fact is completely consistent with the intent of the parties as expressed in the December 1, 1945, contract.

Taxpayers state that from August 1, 1945, they operated as a partnership, each partner being entitled to fifty per cent of the profits. But the clear terms of the December 1, 1945, contract state that they were to operate and manage the winery for John Azevedo until they were issued the basic permits, and that they should receive the earnings of the business as "salary" and "compensation" for their services. (R. 21.) The fact that their salaries or compensation were to be measured by the earnings of the business cannot be taken to show that they owned either the winery or the wine. The claim that, where a taxpayer receives the profits of an operation, he must be the owner of the business property was rejected by this Court in *Carlen* v. *Commissioner*, 220 F. 2d 338, where it appeared, as here, that the parties intended the profit as a measure of the value of the taxpayers' services.

The parties entered into the December 1, 1945, contract as representing their intention that title to the wine and winery was to remain with John Azevedo

until permits were issued the taxpayers. This fact was confirmed on May 3, 1946, in the application for permits made by the corporation. (R. 37, 55.) There is nothing in the record to indicate that the December 1 contract was ever modified. Nevertheless the taxpayers are here attempting to impeach the clear and unambiguous terms of the contract. To allow a party to such a contract to later state for tax purposes, without any convincing evidence that the terms were later modified, that his own contract does not mean what it says, would place a very heavy and unjust burden on the Internal Revenue Service. *Maletis* v. *United States,* 200 F. 2d 97, 98 (C.A. 9th); *Higgins* v. *Smith,* 308 U.S. 473, 477. Compare *Hatch's Estate* v. *Commissioner,* 198 F. 2d 26 (C.A. 9th).

The Tax Court's conclusions are not at all in conflict with the stipulation of facts. The two are easily reconcilable. For example, taxpayers point to the stipulated fact that the corporation filed a return for the fiscal year ending March 3, 1947, on which return it was stated that the inventory as of March 4, 1946, was $445,467.09, presumably the cost of the wine inventory. (R. 34-35.) Taxpayers' conclusion is that this is a concession by the Commissioner that the corporation owned the wine. (Br. 34.) But the Commissioner only admitted that the return was filed; he did not concede the truth of the assertions therein. Obviously if the Commissioner were bound by a taxpayer's return, a tax deficiency could never be assessed. The Tax Court was perfectly correct in stating that (R. 72):

> The mere statement in the corporation income tax return * * * that the corporation had an inventory

> in the amount of $445,467.09 on March 4, 1946, is not competent proof that the corporation in fact acquired and owned the inventory of wine * * *. Such statement in the original and amended corporation returns is self-serving.

The same may be said of taxpayers' contention that the financial statement prepared for Robert and Kershaw as of March 3, 1946, proves that as of that date they owned the wine. Taxpayers' assumption (Br. 35) is that the Commissioner stipulated to the truth of the financial statement. This is not so. Paragraph 6 of the stipulation (R. 35-36) merely says that the financial statement was prepared and that it stated the inventory to be $445,467.09. The statement was completely self-serving, and we might add, stated on its face that it was prepared "without audit." (R. 36.) There is nothing in the stipulation contrary to the Tax Court's finding (R. 72, 73) that Robert and Kershaw never owned the wine and therefore could not have conveyed it to the corporation.

Similarly the Commissioner has not stipulated in paragraph 23 of the stipulation (R. 42-43) that the income from the sales belonged to the corporation, as taxpayers assert (Br. 37-38). True, the Commissioner admitted that the income was "picked up" on the corporate books. But "picked up" means merely that the sales were reported on the corporate books and returns as corporate income, as taxpayers concede. (R. 164.) It is a far different matter to say that the income was "picked up" on the corporate records, which is self-serving, than to say that the Commissioner concedes

the truth and accuracy of the records, which he did not do.[2]

Taxpayers state (Br. 38) that paragraph (p) of their petitions to the Tax Court (R. 12), which asserts that the income belonged to the corporation, was admitted in paragraph (p) of the Commissioner's answer (R. 25). This is absolutely incorrect. The answer admitted only that the matters relating to the sales were picked up on the corporate books. That part of the allegation which claims the income belonged to the corporation was denied in paragraph (p) of the answer.

It will be observed that taxpayers' entire case apparently rests on the contention that the Commissioner has conceded, contrary to his deficiency notices (R. 15-19), that the corporation earned the income in question, and thus has stipulated himself out of court. Taxpayers' resort to such a meritless claim demonstrates the weakness of their case.

It is immaterial whether as between themselves Robert and Kershaw performed their duties under the December 1, 1945, contract as though they were partners. Stipulation 4 (R. 34) is not inconsistent with the Tax Court's holding, for under the terms of the contract they remained managing employees of John Azevedo irrespective of their relationship to each other. Their status as employees was not changed until the winery was conveyed to the corporation after the new permits were issued in August, 1946. In this respect it should

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[2] It is axiomatic that corporate books and records are not determinative of tax liability. As the Supreme Court stated in *Bazley* v. *Commissioner*, 331 U.S. 737, 741: "But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them."

be noted that stipulation 4 states that Robert and Kershaw had a partnership return for the period August 1, 1945, to March 1, 1946, *prepared for filing.* However, the records of the Internal Revenue Service showed that the return was never filed (R. 59), and no proof was offered by the taxpayers that such a return was ever filed (R. 93-95). For that matter, the prepared return appears not to have been signed. (Ex. 3-C.)

The Tax Court was correct in holding (R. 74) that the corporation never owned the wine and that the income from the sales, therefore, was not the income of the corporation. *Helvering* v. *Horst,* 311 U.S. 112; *Blair* v. *Commissioner,* 300 U.S. 5; *Corliss* v. *Bowers,* 281 U.S. 376. The Tax Court was correct in holding (R. 63) that the earnings from the sales of wine represented compensation and salary to Robert and Kershaw for their services in the operation and management of John Azevedo's winery. Such income is necessarily taxable to each individually. Section 22(a) of the 1939 Code (Appendix, infra); *Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Eubank,* 311 U.S. 122.

II

The Assessment of Deficiencies for 1946 Was Not Barred by Section 275 of the Code

The income tax returns for 1946 for Robert Azevedo, Paul Kershaw, Jr., and Irene Kershaw were filed on March 7, 1947, March 15, 1947, and March 20, 1947, respectively. (R. 62.) Under Section 275(a) of the Internal Revenue Code of 1939 (Appendix, *infra*) the notices of deficiencies would have to have been mailed in March, 1950. But Section 275(a) states only the general rule that income taxes shall be assessed within three

years after the return was filed. An exception is provided by Section 275(c) of the 1939 Code (Appendix, *infra*), which states that the tax may be assessed at any time within *five* years after the return was filed—

> If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, * * *.

Section 276(b) of the 1939 Code (Appendix, *infra*) provides as follows:

> Where before the expiration of the time prescribed in section 275 for the assessment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. * * *

If as the Tax Court held the income in question was taxable to taxpayers, then it follows as a matter of arithmetic that they understated their income by more than 25 per cent. And it follows as a matter of law that (1) the five-year statute of limitations applies; and (2) any consent to an extension of time for assessment executed within that period is valid. *Gasper* v. *Commissioner,* 225 F. 2d 284, 288-289 (C.A. 6th).

Consents were executed by Robert Azevedo on February 26, 1952, and by Paul Kershaw, Jr., and Irene Kershaw on January 22, 1952, extending to June 30, 1953, the time within which the income tax for the year 1946 might be assessed. (R. 62.) These consents were executed before the expiration of five years from the dates the returns were filed, and thus served to extend

the period during which to issue the deficiency notices to June 30, 1953. The deficiency notices were mailed by the Commissioner on May 13, 1953 (R. 62), and were, therefore, timely.

Taxpayers assert, however (Br. 41-42), that consents extending the period must be executed within the three-year period allowed by Section 275(a). Such a contention flies in the face of the statutory language used in Section 276(b). That section does not limit the efficacy of consents only to those executed before the expiration of the time prescribed in Section 275(a), but rather refers to Section 275 *in toto*. Subsection (c) of Section 275 is as much a statute of limitations as is subsection (a). The purpose of Section 276(b) clearly is to validate any consent extending whichever period of limitations is applicable as long as the consent was executed before the expiration of the applicable period. The cases so hold. *Hatch* v. *Commissioner,* 14 T.C. 237, reversed on other grounds, 190 F. 2d 254 (C.A. 2d); *Gasper* v. *Commissioner,* decided June 30, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,234), reversed on other grounds, 225 F. 2d 284 (C.A. 6th), *Ketcham* v. *Commissioner,* 2 T.C. 159, 165-166, affirmed 142 F. 2d 996 (C.A. 2d); see *Ewald* v. *Commissioner,* 141 F. 2d 750, 752 (C.A. 6th). The Tax Court was correct in holding (R. 76-77) that the deficiency notices were timely.

CONCLUSION

For the reasons above, the decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

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MARCH, 1957.

APPENDIX

Federal Alcohol Administration Act, c. 814, 49 Stat. 977:

UNLAWFUL BUSINESSES WITHOUT PERMIT

Sec. 3 [As amended by Sec. 1, Act of February 29, 1936, c. 105, 49 Stat. 1152]. In order effectively to regulate interstate and foreign commerce in distilled spirits, wine, and malt beverages, to enforce the twenty-first amendment, and to protect the revenue and enforce the postal laws with respect to distilled spirits, wine, and malt beverages:

* * * * *

(b) It shall be unlawful, except pursuant to a basic permit issued under this Act by the Administrator—

(1) to engage in the business of distilling distilled spirits, producing wine, rectifying or blending distilled spirits or wine, or bottling, or warehousing and bottling, distilled spirits; or

(2) for any person so engaged to sell, offer or delivery for sale, contract to sell, or ship, in interstate or foreign commerce, directly or indirectly or through an affiliate, distilled spirits or wine so distilled, produced, rectified, blended, or bottled, or warehoused and bottled.

This subsection shall take effect sixty days after the date upon which the Administrator first appointed under this Act takes office.

(c) It shall be unlawful, except pursuant to a basic permit issued under this Act by the Administrator—

(1) to engage in the business of purchasing for resale at wholesale distilled spirits, wine, or malt beverages; or

(2) for any person so engaged to receive or to sell, offer or deliver for sale, contract to sell, or ship, in interstate or foreign commerce, directly or indirectly or through an affiliate, distilled spirits, wine, or malt beverages so purchased.

This subsection shall take effect July 1, 1936.

This section shall not apply to any agency of a State or political subdivision thereof or any officer or employee of any such agency, and no such agency or officer or employee shall be required to obtain a basic permit under this Act.

(27 U.S.C. 1952 ed., Sec. 203.)

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income;

and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(c) *Omission From Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * *

(26 U.S.C. 1952 ed., Sec. 275.)

SEC. 276. SAME—EXCEPTIONS.

* * * * *

(b) *Waiver.*—Where before the expiration of the time prescribed in section 275 for the assessment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment

after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

* * * * *

(26 U.S.C. 1952 ed., Sec. 276.)

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